WILLKIE FARR & GALLAGHER LLP **MEMORANDUM**

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Shari Sacks on June 27, 2006

DATED: June 27, 2006

On June 27, 2006, Michael Shapiro, in Willkie Farr & Gallagher LLP's capacity as counsel to the Audit Committee, interviewed Shari Sacks by telephone. Omid Yazdi and Thomas Wang from KPMG also participated in the interview. Ms. Sacks was not represented by counsel.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with Shari Sacks, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

February 16, 2001 E-mail

Ms. Sacks was read Exhibit 1, a February 16, 2001 e-mail from Eric Adachi (Rate Analyst, Supervising Economist, MWWD) to David Schlesinger (Director, MWWD). Mr. Shapiro asked Ms. Sacks to explain the e-mail. Ms. Sacks replied that she did not recall the e-mail but said that Schlesinger is "misusing the term 'contingency reserve.'" She stated that the proper term is "debt service reserve fund." She explained that a debt service reserve fund is a requirement when a transaction is done. She stated that the reserve frequently is paid with cash proceeds from the bond sale itself but can also be established with a letter of credit or a bond surety policy. She said when a debt service reserve fund is funded with cash, if the issuer decides they would prefer to have that cash, they can purchase from the insurer of the bonds a surety as substitute for the cash-funded reserve fund. She explained that a cash-funded reserve fund is subsequently converted to a surety for a premium of 1.5% to 3% of the bond amount, in this case apparently $800,000. She said she believed that with regard to this e-mail, the City took the cash-funded reserve and exchanged it for a surety and then used the cash for capital construction. She explained that if the City could not pay the debt service on the bond, the surety would then be drawn upon.

Mr. Shapiro asked Ms. Sacks whether exchanging a cash-funded reserve for a surety was unusual. She replied that it was not. She said often times people think they want a cash-funded reserve and then decide they would like to have the cash and therefore take out a surety instead. Mr. Shapiro asked Ms. Sacks to explain what Schlesinger meant by asking in the e-mail, "why can't we simply replace the insurance policy with cash from the CIP program?" She replied that Schlesinger was asking if the City could send back the surety policy they already paid for and obtain cash for it. She explained that the City had three years to use bond proceeds and it appeared from the e-mail that the City was not spending the proceeds fast enough.

Schlesinger wanted to avoid IRS penalties and reverse the process by putting the bond proceeds back into the debt service reserve fund instead of spending it on capital improvements. Mr. Shapiro asked Ms. Sacks what "divert funds" meant in the e-mail. She replied that it simply meant taking capital money and placing that money into the debt service reserve fund. She noted that what she had done was to buy the surety in lieu of the cash reserve, and Schlesinger was asking if he could do the reverse: obtain cash by relinquishing the surety. She explained that what Schlesinger proposed was not illegal, it just could not be done. She noted that what she had done was done all the time. She added that many times, people just buy the surety at the outset but other people create the cash reserve and then buy the surety in lieu of the cash.

Mr. Yazdi asked Ms. Sacks to explain the economic advantage of buying the surety bond. She said that by doing so, the City would be able to obtain more proceeds for construction without having to go back into the bond market. She said that the cash funded reserve was always issued as part of the bond and was available for capital projects if a surety was bought to replace the cash. She gave an example of a $300M bond with a $30M cash-funded reserve and said that if a surety is bought to replace the $30M, the City then had an additional $30M it could spend without having to do a new bond offering.

Mr. Shapiro asked Ms. Sacks what "delay issue of the 1999 bonds" meant in the email. Ms. Sacks said that the statement meant that by buying the surety, the City obtained more funding for projects and therefore it could delay having the 1999 bond. Ms. Sacks noted that she left San Diego City government in 1996 and therefore was not involved in the 1999 transaction.

Mr. Yazdi asked Ms. Sacks what "insurance policy" meant in the e-mail. She replied that it was another term for "surety policy" and explained that once a surety was in place, it could not be undone, which meant that Schlesinger's idea was not possible. She noted that the only way to undo a surety was to refinance the whole transaction, which would then become a new transaction.

Conclusion

Mr. Shapiro told Ms. Sacks to contact us if she recalled any new information in the future.

WF&G

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EXHIBIT 1

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Email message text
Object type: [GW.MESSAGE.MAIL]
Item Source: [Sent]
Message ID: [3A8D3A8E.CAB7-9.FM.100.1383633.1.5EE2.1]
From: [Eric Adachi]
To: [;Dave Schlesinger;D5S.MW_DEPT.MWWD]
Subject: [Re: Fwd: Meeting]
Creation date: [2/16/2001 2:34:54 PM]
In Folder: [Mail Box]
Attachments: None
Message: [
Dave,

Checked into your proposal; auditor's just informed me they had looked into it and discovered that it would be considered an inappropriate use of bond funds and therefore was not allowed.

Eric

>>> Dave Schlesinger 02/16 7:35 AM >>>
Eric - I believe a couple of years ago Shari Sacks received FA approval to divert funds from the contingency reserve to the CIP program in order to delay issue of the 1999 bonds. This action cost the sewer ratepayers $800,000 (please verify this #) in terms of the insurance policy preimum that replaced the cash in the reserve. If we are concerned about not meeting the final arbitrage goal (#3) why can't we simply replace the insurance policy with cash from the CIP program? Please provide a response before todays 4:00 PM meeting.

Dave

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